FuncoLand®

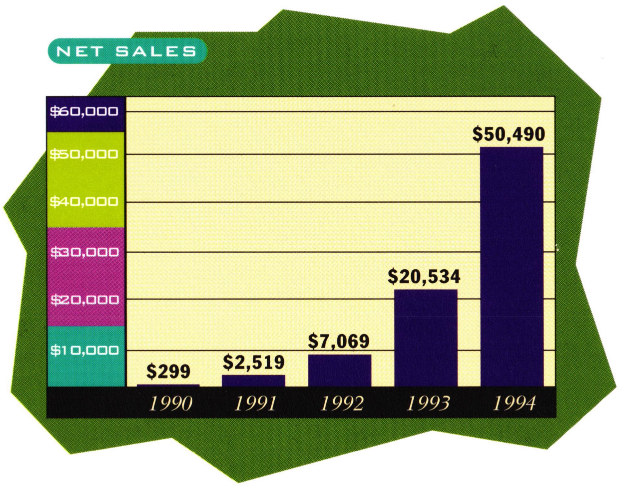
PLAYING to WIN!

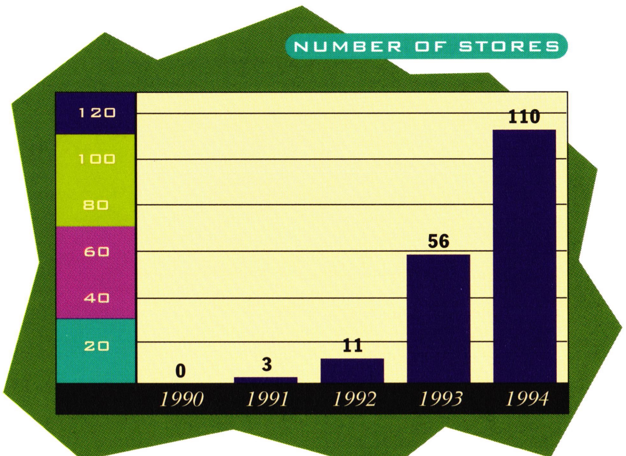
1994 ANNUAL REPORT

Funco, Inc., through its *FuncoLand* stores, is a leading specialty retailer of interactive entertainment products. The Company's product line includes a wide selection of new and previously played video games, hardware and accessories. As of fiscal year end, the Company operated 110 stores in eight metropolitan markets, as well as a mail order operation, and published *Game Informer* magazine. Funco was incorporated in 1988 and is headquartered in Minneapolis, Minnesota. The Company's stock, listed on the NASDAQ market, is traded under the symbol FNCO.

FINANCIAL HIGHLIGHTS

	(in thousands except share and per share data, and number of stores)	*Year Ended* April 3, 1994	April 4, 1993	April 5, 1992	March 31, 1991	April 1, 1990
STATEMENT OF OPERATIONS DATA:	Net sales	$50,490	$20,534	$7,069	$2,519	$299
	Net income (loss)	$ 880	$ (520)	$ 20	$ 85	$ 4
	Net income (loss) per share	$ .15	$ (.12)	$ .01	$ .03	–
	Weighted average number of shares	5,807,798	4,164,247	3,403,777	3,392,241	3,392,241
	Stores open at end of year	110	56	11	3	–
BALANCE SHEET DATA:	Total assets	$24,707	$ 7,553	$1,975	$ 405	$138
	Long-term obligations	$ 557	$ 457	$ 183	$ 33	$ 77
	Shareholders' equity	$18,653	$ 4,484	$ 202	$ 95	$ 10





DEAR SHAREHOLDER:

Fiscal 1994 was a winning year for Funco, with customers, employees and shareholders participating in our success. We doubled our store base, adding 54 new retail locations, and created a strong East Coast presence. We achieved revenues of $50,490,000 reflecting an increase of 146% over 1993. Our concept of buying and selling previously played video games through *FuncoLand* stores has provided customers with exceptional value and has produced a high return on investment at the store level. In addition, our *Game Informer* magazine has continued its rapid growth with paid circulation rising dramatically from 60,000 one year ago to over 110,000 today.

Our strategy of targeting major metro areas for rapid, multiple store rollouts in high-traffic strip centers has proven to be a winner. In fiscal 1994, we added 14 stores in Detroit, expanded to the East Coast with 29 new stores in the suburban New York metropolitan market and opened our first two stores in Philadelphia and Washington, D.C. In addition, we operated 12 stores in Minneapolis, 14 stores in Dallas, 32 stores in Chicago and 5 stores in Milwaukee, for a total of 110 stores in eight markets at fiscal year end.

Our rapid expansion strategy delivers substantial economies in marketing, distribution, store construction and leasing, and gives us a preemptive presence in our markets. We will continue to apply this competitive edge in the future as we plan to open approximately 60 new stores in fiscal 1995, adding to our current markets and entering new metropolitan areas including Boston and Houston.

To support our continuing expansion, Funco successfully completed a second public stock offering in June 1993. The $18 million in combined proceeds from our two public stock offerings provide us with a solid equity base from which to operate in a dynamic market.

Today, more than 75 million people regularly play video games and more than one third of all United States households own video game systems. Sega and Nintendo, the two predominant suppliers of video games and equipment, reported combined sales in excess of $5 billion in 1993, adding to the more than 500 million game cartridges that have been purchased in the United States since 1986. This installed base holds enormous potential for resale and points to an exciting future for Funco as we continue to be the leader in a market niche we pioneered.

At Funco we have assembled a group of talented employees and a management team with the experience necessary to strengthen our position as the dominant provider of previously played interactive entertainment products. We are committed to continued growth and profitability. On behalf of the Company's employees and Board of Directors, I thank you for your support and confidence in Funco, Inc.

Sincerely,

David R. Pomije

David R. Pomije
President and CEO

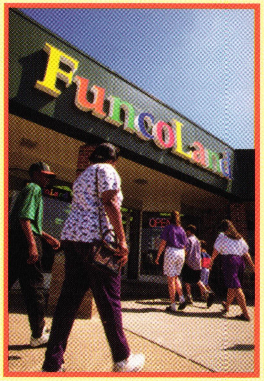
June 20, 1994

INVENTING *the game*

In the nearly 20 years since the earliest video game was introduced, the interactive entertainment industry has emerged to become a strong and growing $5 billion market. Consumers have transformed their televisions into more than just instruments for passive viewing, finding them a worthy opponent in interactive play. As technology has evolved from 8-bit to 16-bit formats and beyond, games have become more elaborate and challenging and have attracted a much wider audience. Today, nearly half of the 75 million video game players are over 18 years old.

In 1988, Funco's founder and president, David R. Pomije, discovered the vast and then largely untapped market for previously played video games. Unlike videotapes or cassettes, video games are durable – they have no moving parts and consequently do not wear out. A previously played video game is literally as good as new. Capitalizing on an informal trading process that initially developed among players through garage sales and classified ads, Funco's value driven concept is to purchase previously played video games and equipment from the public and resell them at a profit, in a fun and professional environment. The response was instant and overwhelming. In 1990, the first *FuncoLand* store opened in Minneapolis and in the three years since, the Company has grown into a 110 store retail chain in eight major metropolitan markets.

Today, the development of new interactive entertainment is dominated by two key players: Sega and Nintendo. Each year, video game manufacturers release hundreds of new titles while they cease production of many others. The limited availability of many popular games fuels demand in the secondary, resale market. *FuncoLand* stores provide the public with a formalized way to trade and recirculate the huge existing base of video games. The Funco concept gives consumers the chance to realize value from games they no longer want – adding to their purchasing power for both new and previously played games.



Making all the right moves

As a leading retailer of both previously played and new interactive entertainment software, hardware and accessories, Funco has discovered a few keys to success...

Superior Selection

Each *FuncoLand* store offers approximately 1,500 different titles including hundreds that are no longer manufactured, compared to approximately 500 titles available at other specialty retailers, consisting primarily of recent releases.

In-Store Trial

At *FuncoLand* stores, customers are encouraged to try any game – new or previously played – before they buy it. This practice is designed to increase customer satisfaction and minimize product returns.

Low Prices

FuncoLand stores sell previously played games for an average of half their original retail price, including many below $5. New products are competitively priced, and all products, whether new or previously played, are sold with a 90-day warranty.

Product Buyback

FuncoLand stores purchase games, hardware and accessories from customers and offer them a check or store credit in return. Many customers choose store credit, putting their money back into the product category.

Dedicated employees are the driving force behind it all, providing a superior level of customer service. All of these keys to the game combine to create a positive store experience and a loyal customer base. Ringing registers and the winning smiles of satisfied *FuncoLand* customers serve as proof that the Company is making all the right moves.

Playing it SMART

As the market leader, Funco has a head start in game strategy. Being ***first, fast, bigger and better*** has allowed Funco to stay ahead of the competition while delivering strong, stable profit margins and providing exceptional value and service to customers.

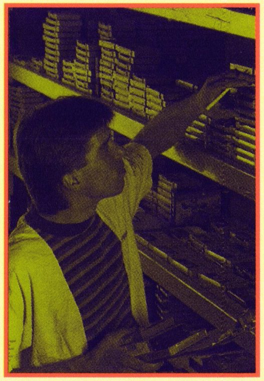
FuncoLand stores average 1,700 square feet and are located in high-traffic power strip centers with easy accessibility and high visibility. In addition to a broad selection of game titles, low prices, product buyback and in-store trial, customers find superior service. Funco emphasizes strong customer interaction and knowledge of the product category, having developed systems which facilitate the hiring, training and development of outstanding store managers and associates.

FuncoLand's customers supply much of each store's own inventory requirements. In addition, the stores are supported by the Company's distribution center and mail order operation for specific titles or inventory balancing. Products are priced using a sophisticated bid/ask pricing model, based on supply and demand, that is updated regularly by corporate management.

The key is knowing which titles to sell at what price and when. With four years of history on over 2,000 items, Funco is experienced at evaluating previously played inventory and developing the necessary systems to manage it.

The Company's sophisticated management information systems provide daily sales figures, margins and inventory by item for all stores. Plans include continued investment in both hardware and software capable of handling further rapid expansion of the store base, including distribution, financial control and capture of customer demographic data.

Funco's marketing strategy focuses on building awareness through television advertising, supported by newspaper ads and inserts, in-store promotions and direct mail. Funco also takes advantage of special promotions on top titles in conjunction with game manufacturers.

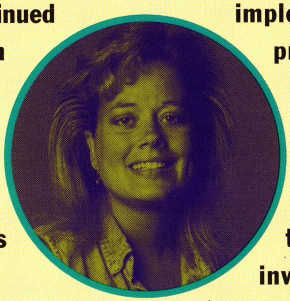


In fiscal 1994, Funco successfully promoted the mega hits MORTAL KOMBAT®, MADDEN NFL™ '94 and NBA® JAM™, introducing many consumers to the ***FuncoLand*** store concept.

Funco's ***Game Informer*** magazine provides customers with informative reviews of upcoming new releases, secret tips and game strategies. With one of the largest paid subscriber bases in the industry, the magazine is now a profit center for the Company and is expected to continue its robust growth.

Playing to win!

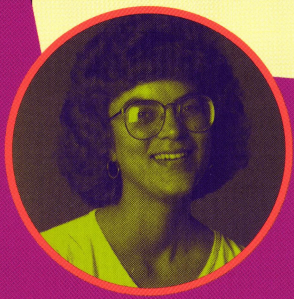
Funco is playing to win. Firmly established as the market leader in a unique and profitable niche, the Company doubled its store base and generated solid earnings in fiscal 1994. The Company is well positioned for continued profitable growth through store expansion, revenue and margin growth and further leveraging of its expense structure.



Funco's careful investment in the infrastructure necessary to support a rapidly growing business has paid off. Refinement of information and control systems is ongoing and the Company continues to implement programs and processes designed to maximize performance. During fiscal 1994, the Company reconfigured its distribution center and invested approximately $700,000 in upgrading its information systems to handle a greater number of stores efficiently and effectively.

Funco recognizes that recruiting, developing and motivating high quality employees is critical to its success. In fiscal 1994, the Company further strengthened its management team by adding new managers in several key positions, including an East Coast regional manager to oversee operations of existing stores and facilitate new store openings.

The strength of the Funco concept, together with potentially unlimited opportunity in the interactive entertainment industry, promises continued growth and profitability, creating lasting long-term value and keeping the Company's customers, employees and shareholders in the winner's circle.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The Company has grown from three retail stores at the end of fiscal 1991 to 110 at the end of fiscal 1994. The Company has stores in the Minneapolis/St. Paul, Dallas, Chicago, Milwaukee, Detroit, New York, Philadelphia and Washington, D.C. metropolitan areas. The Company plans to open approximately 60 new stores in fiscal 1995.

The Company's business is seasonal with the majority of its annual net sales generated during the third and fourth fiscal quarters, which include the holiday selling season. As a result of this seasonality and the fact that the Company expects to incur continued expenses in connection with its planned store expansion, the Company anticipates losses in each of the first two quarters of fiscal 1995. Profitability in the last two quarters of fiscal 1995 will depend on performance of existing stores and attainment of projected performance by new stores.

In addition to seasonality, key factors affecting net sales and profitability include the number of stores in operation and their relative maturities, new store openings, location of stores and customer demographics, merchandise selection, competition and acceptance of current marketing techniques. Management believes that most new stores will attain mature store sales levels within six months after commencing operations and thereafter will experience only modest sales growth. No assurance can be given, however, that new stores will achieve, or that current stores will sustain, desired operating results and profitability.

RESULTS OF OPERATIONS

The following table sets forth certain items in the statements of operations expressed as (i) percentages of net sales for the years indicated and (ii) percentage changes from the prior year:

	Fiscal Year 1994	Fiscal Year 1993	Fiscal Year 1992	Percentage Increase (Decrease) 1994 over 1993	Percentage Increase (Decrease) 1993 over 1992
Net sales	100.0%	100.0%	100.0%	145.9%	190.5%
Cost of sales	58.3	57.2	52.7	150.8	215.1
Gross profit	41.7	42.8	47.3	139.4	163.0
Retail operating expenses	27.3	27.6	26.2	142.5	206.1
General and administrative expenses	11.9	17.5	20.6	68.4	145.5
Operating income (loss)	2.5	(2.3)	0.5	NA	NA
Interest expense	(0.2)	(0.4)	(0.2)	(9.8)	441.2
Interest income	0.3	0.2	0.1	350.0	414.3
Income tax provision	0.9	–	–	NA	NA
Net income (loss)	1.7%	(2.5%)	0.4%	NA	NA

Comparison of Fiscal 1994 to Fiscal 1993

The Company derived approximately 97% of its fiscal 1994 net sales from its retail operations. The balance of net sales was attributable to the publication of *Game Informer* magazine. Net sales increased from $20,534,000 in fiscal 1993 to $50,490,000 during fiscal 1994, an increase of 145.9%. The growth in net sales occurred primarily as a result of new store openings, with net sales of new stores accounting for approximately $18,000,000 of fiscal 1994 net sales. Comparable store sales increased 4% from fiscal 1993. The Company operated 110 stores at the end of fiscal 1994 compared to 56 stores at the end of fiscal 1993.

Cost of sales increased from $11,741,000 in fiscal 1993 to $29,443,000 during fiscal 1994, a 150.8% increase. This increase was primarily attributable to higher net sales levels resulting from the increase in the number of stores. Cost of sales as a percentage of net sales increased from 57.2% to 58.3% as a result of an increased proportion of sales generated from higher cost new merchandise categories as compared with sales in previously played product categories. This occurred primarily as the Company promoted several new product offerings (MORTAL KOMBAT®, MADDEN NFL™ '94 and NBA® JAM™) as a means of introducing consumers to the Company's stores. Distribution center costs also contributed to the increase in cost of goods as a percent of sales due to freight costs associated with the Company's East Coast stores.

Retail operating expenses increased from $5,675,000 in fiscal 1993 to $13,760,000, a 142.5% increase. This increase was primarily attributable to an increase in the number of stores. Retail operating expenses as a percentage of net sales decreased from 27.6% to 27.3%. The Company increased its store base by 54 locations in fiscal 1994 as compared to an increase of 45 locations in fiscal 1993. General and administrative expenses increased from $3,582,000 in fiscal 1993 to $6,031,000, or 68.4%, but decreased as a percentage of net sales from 17.5% to 11.9%. The dollar increase in general and administrative expenses was primarily attributable to the further staffing and development of corporate functions necessary to support the expanding retail operations. The decrease in general and administrative expenses as a percentage of net sales reflects leveraging resulting from the expanding store base.

The Company generated operating income of $1,256,000 in fiscal 1994 as compared to an operating loss of $464,000 in fiscal 1993.

Interest income increased from $36,000 in fiscal 1993 to $162,000 in fiscal 1994, an increase of 350.0%. This is primarily due to investment of proceeds received from the Company's second public stock offering in June 1993. The Company recorded an income tax provision of $455,000 for fiscal 1994. Due to operating losses, no income tax provision had been recorded in fiscal 1993. As a result of the above factors, the Company generated net income of $880,000 in fiscal 1994 as compared to a net loss of $520,000 in fiscal 1993.

Comparison of Fiscal 1993 to Fiscal 1992

The Company derived approximately 97% of its fiscal 1993 net sales from its retail operations. The balance of net sales was attributable to the publication of *Game Informer* magazine. Net sales increased from $7,069,000 in fiscal 1992 to $20,534,000 during fiscal 1993, an increase of 190.5%. The growth in net sales occurred primarily as a result of new store openings, with net sales of new stores accounting for approximately $13,000,000 of fiscal 1993 net sales. The Company operated 56 stores at the end of fiscal 1993 compared to eleven stores at the end of fiscal 1992.

Cost of sales increased from $3,726,000 in fiscal 1992 to $11,741,000 during fiscal 1993, a 215.1% increase. This increase was primarily attributable to higher net sales levels resulting from the increase in the number of stores. Cost of sales as a percentage of net sales increased from 52.7% to 57.2%. Contributing to this increase was a change in the Company's sales mix, with a higher proportion of fiscal 1993 net sales generated from new hardware systems. These products generally have both a higher cost and a higher selling price but generate lower gross margins than previously played merchandise. Also, the costs of publishing *Game Informer* magazine increased at a faster rate than the growth of magazine revenues. In addition, the Company followed a more aggressive purchase pricing strategy for previously played games than in the prior year to ensure adequate inventory levels for the expanding base of stores. Favorably impacting cost of goods sold as a percentage of sales was the allocation of costs associated with the Company's distribution center over the larger store base.

Retail operating expenses increased from $1,854,000 in fiscal 1992 to $5,675,000 in fiscal 1993, a 206.1% increase. This increase was primarily attributable to an increase in the number of stores. Retail operating expenses as a percentage of net sales increased from 26.2% to 27.6%, reflecting preopening and start-up expenses for new stores, including recruitment, travel, training and advertising. The Company increased its store base by 45 locations in fiscal 1993 as compared to an increase of eight locations in fiscal 1992.

General and administrative expenses increased from $1,459,000 in fiscal 1992 to $3,582,000 in fiscal 1993, or 145.5%, but decreased as a percentage of net sales from 20.6% to 17.5%. The dollar increase in general and administrative expenses was primarily attributable to the further staffing and development of corporate functions necessary to support the expanding retail operations. The decrease in general and administrative expenses as a percentage of net sales reflects leveraging resulting from the expanding store base.

The Company incurred an operating loss of $464,000 in fiscal 1993 as compared to operating income of $30,000 in fiscal 1992.

Net interest expense increased from $10,000 in fiscal 1992 to $56,000 in fiscal 1993, primarily reflecting interest on increased average borrowings and capital lease obligations.

The Company had no income tax expense in either fiscal 1993 or fiscal 1992. See Note 8 of Notes to the Financial Statements.

As a result of the above factors, the Company incurred a net loss of $520,000 in fiscal 1993 as compared to net income of $20,000 in fiscal 1992.

Seasonality and Quarterly Results

The Company's business is seasonal with a majority of net sales generated in the third and fourth quarters, which include the holiday selling season. For the 56 stores operating the full 12 months in fiscal 1994, 37% of net sales occurred in the first half of the year and 63% in the second half of the year. Accordingly, annual profitability is heavily dependent on third and fourth quarter net sales. In addition to sales seasonality, the Company's quarterly results are also affected by the number and timing of new store openings. The Company's rapid growth may obscure the impact of seasonal influences. Because of the seasonality of the Company's business, results for any quarter are not necessarily indicative of the results that may be achieved for a full fiscal year.

Net sales, gross profit and operating income (loss) for the past eight fiscal quarters, together with the number of stores open at the end of each quarter, are presented in the following table:

	Fiscal 1994				Fiscal 1993			
(in thousands except number of stores)	*1st Quarter*	*2nd Quarter*	*3rd Quarter*	*4th Quarter*	*1st Quarter*	*2nd Quarter*	*3rd Quarter*	*4th Quarter*
Net sales	$5,553	$8,201	$21,730	$15,006	$1,496	$2,879	$8,912	$7,247
Gross profit	2,368	3,516	8,601	6,562	581	1,055	3,862	3,295
Operating income (loss)	(919)	(742)	2,075	842	(632)	(745)	720	193
Stores open at quarter end	69	85	105	110	20	29	49	56

Although the results presented above may not be indicative of future trends or performance, the Company anticipates that quarterly net sales and operating income will continue to be significantly impacted by seasonality patterns.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Liquidity and Capital Resources

The Company's primary ongoing financing requirements are for new store expansion and inventory. During fiscal 1994, 1993 and 1992, the Company had net cash provided by (used in) operating activities of $199,000, $(876,000) and $299,000, respectively. The operating activity which most significantly impacted cash was inventory expansion, which included approximately $2,500,000 for the 54 stores opened in fiscal 1994.

In fiscal 1994, the Company generated net proceeds of $13,150,000 through a second offering of 1,302,500 shares of its common stock at a price of $11.00 per share. The Company also sold 58,150 shares of stock through the exercise of stock options at prices ranging from $1.33 to $6.67, generating net proceeds of $102,000.

The Company invested $5,234,000 in capital expenditures, which included $3,500,000 for new stores and $700,000 related to an ongoing information system conversion project.

Subsequent to its fiscal year end, the Company amended its credit facility with a commercial bank to provide a $1,000,000 annual revolving line of credit, which will seasonally increase to $4,000,000. The interest rate on outstanding borrowings under the facility will be equal to the bank's reference rate plus one half of one percent. This facility is collateralized by substantially all inventory, accounts receivable and general intangibles of the Company. Certain advances under this facility are subject to eligible inventory or cash equivalents. The facility requires the Company to maintain certain financial ratios and achieve certain operating results.

During fiscal 1995, the Company plans to incur capital expenditures of $5,500,000. These will include expenditures to open approximately 60 new stores (11 of which were open at June 20, 1994), and to complete the information systems conversion project. The average capital cost to open a new store in fiscal 1995 is expected to be $60,000 for equipment, leasehold improvements and other capital expenditures. Additionally, the Company will incur costs of approximately $30,000 per store for inventory and pre-opening expenses.

The Company believes that cash from operations and funds available under its revolving credit facility will provide sufficient funds for financing planned store openings, working capital needs and other capital expenditures for at least 12 months.

Other Matters

The Company does not believe that its business has been significantly impacted by inflation.

Report of Management

The management of Funco, Inc. is responsible for the preparation, integrity and objectivity of the accompanying financial statements. The financial statements have been prepared in accordance with generally accepted accounting principles and include amounts which are based upon estimates and informed judgments of management.

In fulfilling its responsibility for the integrity of financial information, management has established a system of internal controls which provides reasonable assurance that transactions are executed in accordance with management's intention and authorization, that assets are properly safeguarded and accounted for, and that financial statements are prepared in accordance with generally accepted accounting principles. The concept of reasonable assurance is based on the recognition that there are inherent limitations in all systems of internal control, and that the cost of such systems should not exceed the benefits derived. These systems are periodically reviewed and modified in response to changing conditions.

The management of Funco, Inc. also recognizes its responsibility for fostering a strong ethical climate so that the Company's affairs are conducted according to the highest standards of personal and business conduct.

The adequacy of the Company's internal accounting controls, accounting principles employed, scope of audit work and quality of financial reporting are reviewed by the Audit Committee of the Board of Directors, consisting solely of outside directors. The independent auditors meet with and have confidential access to the Audit Committee to discuss auditing and financial reporting issues with or without management present.

Report of Independent Auditors

Board of Directors and Shareholders
Funco, Inc.
Minneapolis, Minnesota

We have audited the accompanying balance sheets of Funco, Inc. as of April 3, 1994 and April 4, 1993, and the related statements of operations, shareholders' equity and cash flows for each of the three years in the period ended April 3, 1994. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Funco, Inc. at April 3, 1994 and April 4, 1993, and the results of its operations and its cash flows for each of the three years in the period ended April 3, 1994, in conformity with generally accepted accounting principles.

Ernst & Young

Minneapolis, Minnesota
May 20, 1994

Statements of Operations *(in thousands, except share and per share data)*

	Year ended April 3, 1994	April 4, 1993	April 5, 1992
Net sales	$50,490	$20,534	$7,069
Cost of sales	29,443	11,741	3,726
Gross profit	21,047	8,793	3,343
Retail operating expenses	13,760	5,675	1,854
General and administrative expenses	6,031	3,582	1,459
Operating income (loss)	1,256	(464)	30
Interest expense	(83)	(92)	(17)
Interest income	162	36	7
Net income (loss) before income taxes	1,335	(520)	20
Income tax provision	455	–	–
Net income (loss)	$ 880	$ (520)	$ 20
Net income (loss) per share	$ .15	$ (.12)	$ .01
Weighted average number of common and common equivalent shares	5,807,798	4,164,247	3,403,777

See accompanying notes.

Balance Sheets

(in thousands, except share data)

	Year ended April 3, 1994	April 4, 1993
Assets		
Current Assets		
Cash and cash equivalents	$ 2,930	$1,902
Marketable securities	7,002	–
Accounts receivable	387	308
Inventories	6,442	2,377
Prepaid expenses	1,148	421
Total current assets	17,909	5,008
Property and equipment, net of accumulated depreciation and amortization	6,563	2,426
Other assets, net of accumulated amortization	235	119
Total assets	$24,707	$7,553
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable	$ 1,954	$1,170
Accrued liabilities	2,564	983
Current portion of long-term debt and capital lease obligation	429	192
Deferred revenue	550	267
Total current liabilities	5,497	2,612
Long-term debt	–	4
Capital lease obligations	307	287
Accrued rent	250	166
Shareholders' Equity		
Common stock (issued and outstanding: 5,736,454 in 1994 and 4,375,804 in 1993)	57	44
Additional paid-in capital	17,332	4,041
Retained earnings	1,264	399
Total shareholders' equity	18,653	4,484
Total liabilities and shareholders' equity	$24,707	$7,553

See accompanying notes.

Statements of Cash Flows (in thousands)

		Year ended	
	April 3, 1994	April 4, 1993	April 5, 1992
Net income (loss)	$ 880	$ (520)	$ 20
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Cash flows from operating activities			
Depreciation and amortization	1,356	467	109
Deferred tax asset	(156)	–	–
Loss on investment in marketable securities	101	–	–
Changes in operating assets and liabilities:			
Accounts receivable	(79)	(245)	(51)
Inventories	(4,065)	(1,451)	(832)
Prepaid expenses	(622)	(348)	(66)
Accounts payable	784	53	958
Accrued liabilities	1,717	950	112
Deferred revenue	283	218	49
Net cash provided by (used in) operating activities	199	(876)	299
Cash flows from investing activities			
Investment and dividend reinvestment in marketable securities	(22,289)	–	–
Sales of marketable securities	15,164	–	–
Additions to property and equipment	(5,234)	(1,982)	(506)
Increase in other assets	(251)	(100)	(95)
Repayment of note receivable from related party	–	–	79
Net cash used in investing activities	(12,610)	(2,082)	(522)
Cash flows from financing activities			
Payments of long-term debt	(4)	(3)	(52)
Proceeds from borrowing on line of credit	–	450	250
Payments against borrowings on line of credit	–	(600)	(100)
Proceed from note with officer	–	–	100
Proceeds from interim financing obligations	–	1,060	–
Payments of interim financing obligations	–	(1,060)	–
Proceeds from sale/leaseback of equipment	557	126	234
Payments of obligations under capital leases	(366)	(146)	(11)
Net proceeds from issuance of common stock	13,150	4,855	100
Proceeds from issuing stock to employees	102	–	–
Distributions to shareholders	–	(54)	(113)
Net cash provided by financing activities	13,439	4,628	408
Cash and cash equivalents			
Increase in cash and cash equivalents	1,028	1,670	185
Cash and cash equivalents at beginning of period	1,902	232	47
Cash and cash equivalents at end of period	$ 2,930	$ 1,902	$ 232

See accompanying notes.

STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Total Shareholders Equity
Balance at March 31, 1991	3,000	$ –	$ –	$ 95	$ 95
Common stock issued	226	2	198		200
Transfer to adjust common stock to authorized par value as a result of recapitalization		30	(30)		–
Distributions to shareholders				(113)	(113)
Net income				20	20
Balance at April 5, 1992	3,226	32	168	2	202
Common stock issued, net of costs	1,150	12	4,844		4,856
Distributions to shareholders				(54)	(54)
Recapitalization resulting from termination of S corporation status			(971)	971	–
Net loss				(520)	(520)
Balance at April 4, 1993	4,376	44	4,041	399	4,484
Common stock issued, net of costs	1,360	13	13,239		13,252
Tax benefits of stock options			52		52
Unrealized loss on securities, net of tax				(15)	(15)
Net income				880	880
Balance at April 3, 1994	5,736	$57	$17,332	$1,264	$18,653

See accompanying notes.

1. SIGNIFICANT ACCOUNTING POLICIES

Nature of Business – **Funco, Inc. is engaged in the business of providing interactive home entertainment primarily through the purchase and resale of previously played video games and related hardware and accessory items through its *FuncoLand* stores and mail order operation. It also publishes a video game magazine, *Game Informer*. The Company was incorporated in Minnesota in March 1988.**

Revenue Recognition – **Revenue from retail sales of the Company's products is recognized at the time of sale. Deferred revenue represents amounts received for subscriptions to a specified number of future video game magazine issues. Subscription revenue is recognized on a straight-line basis as the magazine issues are delivered.**

Fiscal Year – **The Company's fiscal year ends on a Sunday on or near March 31, which completes a 52 or 53 week reporting period. Unless otherwise stated, references to years in this report relate to fiscal years rather than to calendar years.**

Fiscal Year	Ended	Weeks
1992	April 5, 1992	53
1993	April 4, 1993	52
1994	April 3, 1994	52

Cash Equivalents – **Cash equivalents represent short-term investments with a maturity of three months or less at the time of purchase. Short-term investments are recorded at cost which approximates market.**

Marketable Securities – **Marketable securities are carried at fair value, with any unrealized gains and losses, net of tax, reported as a separate component of shareholders' equity. Realized gains and losses and declines in value judged to be other-than-temporary on marketable securities are included in investment income.**

Inventories – **Inventories consist of new and previously played video games, hardware and accessories and are valued at the lower of cost, determined using the first-in, first-out (FIFO) method, or market.**

Property and Equipment – **Property and equipment are recorded at cost. The Company uses the straight-line method of computing depreciation based on the assets' estimated useful lives.**

Other Assets – **Included in other assets are costs incurred in leasing and developing new locations and other intangible assets which the Company has capitalized and is amortizing over periods ranging from one to five years. Accumulated amortization was $63,000 and $67,000 for the years 1994 and 1993, respectively.**

Income Taxes – **The Company accounts for income taxes under Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." The adoption of this Statement in fiscal 1993 did not have a material impact on the financial statements.**

Prior to the August 12, 1992 initial public offering, the Company was incorporated as an S corporation under the Internal Revenue Code. Net income (loss) of the Company was reflected in the taxable income of the individual shareholders and no income tax expense was reflected in the Company's statements of operations for prior periods.

Net Income (Loss) Per Share – **Net income (loss) per share is based on the weighted average number of common and dilutive common equivalent shares outstanding during the period. Common share equivalents include the dilutive effect of stock warrants and common stock options using the treasury stock method.**

Reclassifications – Certain items in 1992 and 1993 have been reclassified to conform with the 1994 presentation.

2. Financing Arrangements

Subsequent to the fiscal year end, the Company's bank credit facility was amended to provide for a $1,000,000 annual revolving line of credit, seasonally increasing to $4,000,000. The interest rate on outstanding borrowings under the facility is equal to the bank's reference rate plus one half of one percent. This facility is collateralized by substantially all inventory, accounts receivable and general intangibles of the Company.

Certain advances under this facility are subject to eligible inventory or cash equivalents. The facility requires the Company to maintain certain financial ratios and achieve certain operating results.

3. Leases

Capital Leases – The Company has leased equipment under sale/leaseback and lease financing arrangements. Under the Company's sale/leaseback transactions, equipment has generally been sold at net book value with no gain or loss recorded. The equipment capitalized under these arrangements and included in property and equipment is as follows:

(in thousands)	*1994*	*1993*
Equipment	$1,255	$ 633
Accumulated amortization	(338)	(142)
	$ 917	$ 491

Amortization of leased assets is included in depreciation and amortization expense.

Equipment at a cost of $66,000, $250,000 and $23,000 was acquired in exchange for obligations under capital leases in the years 1994, 1993 and 1992, respectively. Future minimum payments required under capital leases consist of the following for the years ending after 1994:

(in thousands)	
1995	$472
1996	305
1997	15
	792
Less amounts representing interest	(60)
Present value of future minimum lease payments	$732

Total interest paid, including interest on short-term borrowings and capital leases, was $83,000, $92,000 and $17,000 for the years 1994, 1993 and 1992 respectively.

Operating Leases – The Company has rental commitments for office space, retail space and office equipment under non-cancelable operating leases. Certain of these leases contain provisions for renewal options and most require the Company to pay other lease related costs.

Future minimum lease payments under non-cancelable operating leases consist of the following:

(in thousands)	
1995	$2,761
1996	2,501
1997	1,320
1998	295
1999	124
	$7,001

Rent expense was $1,968,000, $690,000 and $200,000 for the years 1994, 1993 and 1992, respectively.

4. Property and Equipment Consist of the Following:

(in thousands)	*1994*	*1993*
Furniture and fixtures	$ 2,123	$ 892
Equipment	3,378	1,273
Vehicles	64	64
Leasehold improvements	2,682	718
	8,247	2,947
Less accumulated depreciation	(1,684)	(521)
Net property and equipment	$ 6,563	$2,426

5. Accrued Liabilities Consist of the Following:

(in thousands)	*1994*	*1993*
Purchase credit memos payable	$ 628	$274
Employee compensation and related taxes	677	327
Sales tax payable	426	136
Income tax payable	389	–
Other accrued liabilities	444	246
Total accrued liabilities	$2,564	$983

6. Shareholders' Equity

In May 1992, Board of Directors action, which was approved by the shareholders, resulted in a recapitalization of the Company, authorizing 1,000,000 shares of preferred stock and 14,000,000 shares of common stock, both with a par value of $.01 per share. No preferred stock has been issued.

In March 1992, an officer of the Company exercised an option to purchase 112,902 shares of the Company's common stock. A $100,000 promissory note due the officer was exchanged as consideration for the option exercise.

On August 12, 1992, the Company completed the sale of 1,000,000 shares of its common stock to the public at a price of $5.00 per share. On September 14, 1992, the Company's underwriter purchased 150,000 shares of common stock from the Company, also at price of $5.00 per share, pursuant to the exercise of the underwriter's over-allotment option. The combined sales generated net proceeds of $4,856,000.

On June 22, 1993, the Company completed the sale of 1,302,500 shares of its common stock at a price of $11.00 per share.

7. Stock Options and Warrants

Under the terms of the Company's various stock option plans, 850,000 shares of common stock have been reserved for issuance to directors, officers and employees, upon the exercise of stock options. The stock options are exercisable over periods up to ten years from date of grant and include incentive stock options and non-qualified stock options.

At April 3, 1994, there were 510,529 options outstanding of which 25,180 were exercisable. A summary of stock option transactions is as follows:

		Shares Reserved	Shares Outstanding	Price per Share
Balance at	March 31, 1991	–	–	
	Reserved	750,000	–	
	Granted	(281,250)	281,250	$1.33
Balance at	April 5, 1992	468,750	281,250	1.33
	Reserved	100,000	–	
	Granted	(140,250)	140,250	5.00 - 6.67
	Canceled	5,250	(5,250)	6.67
Balance at	April 4, 1993	433,750	416,250	1.33 - 6.67
	Granted	(196,504)	196,504	11.00 -18.00
	Canceled	44,075	(44,075)	5.25 -14.50
	Exercised	–	(58,150)	1.33 - 6.67
	April 3, 1994	281,321	510,529	$1.33-$18.00

Annually, beginning on May 1, 1994, the Company will reserve an additional 1% of the total number of Common Stock shares outstanding at fiscal year end. Subsequent to April 3, 1994, the Company has reserved an additional 57,365 shares for use in its stock option plan.

Pursuant to the initial public offering of the Company's stock, a warrant to purchase 100,000 shares of its common stock at $6.00 per share was issued to the underwriter of the offering. This warrant extends for a period of four years, commencing August 12, 1993. As part of a private placement of promissory notes in May 1992, the Company issued warrants to purchase 30,000 shares of its common stock at $5.00 per share to several investors. The warrants are exercisable for a period of four years, commencing in May 1993. In April 1993, the Company granted to a consultant a five year warrant to purchase 7,000 shares of common stock at $12.75 per share. The warrant is exercisable for a period of 5 years commencing June 1, 1993. In conjunction with the issuance of these warrants, the Company reserved 137,000 shares of common stock.

Subsequent to year end, investors exercised warrants to puchase 30,000 shares of common stock at a price of $5.00 per share.

8. Income Taxes

As a result of its initial public offering on August 12, 1992, the Company terminated its S corporation status. The Company is subject to income taxes on income earned subsequent to the date of the S corporation termination.

Had the Company operated as a C corporation from inception, the Company would have recorded pro forma income tax benefits of approximately $29,000 in 1993 and expense of approximately $5,000 in 1992. This results in pro forma net loss of $491,000 in 1993 and net income of $15,000 in 1992 and pro forma net loss per share of $.12 in 1993 and no income per share in 1992.

Significant components of the provision for income taxes for fiscal 1994 are as follows:

(in thousands)		*1994*
Current	Federal	$353
	State	128
		481
Deferred	Federal	(19)
	State	(7)
		(26)
		$455

Deferred income taxes are due to temporary differences between carrying values of certain assets and liabilities for financial reporting and income tax purposes. Significant components of deferred taxes at April 3, 1994 and April 4, 1993, are as follows:

(in thousands)		*1994*	*1993*
Deffered Assets	Deferred revenue	$ –	$ 55
	Accrued rent	142	99
	Inventory reserve	36	15
	Other	12	5
		190	174
Deferred Liabilities	Prepaid commissions	–	14
	Prepaid advertising	–	37
	Depreciation	34	–
		34	51
	Net deferred tax assets before valuation allowance	156	123
	Valuation allowance for net deferred tax asset	–	(123)
	Net deferred tax asset	$156	$ –

Income taxes of $163,000 were paid in 1994.

A reconciliation of the Company's tax rate at the federal statutory rate of 34% is as follows:

(in thousands)	*1994*
Expected tax expense	$454
State income tax	80
Change in valuation allowance	(123)
Other	44
	$455
Effective tax rate	34.1%

BOARD OF DIRECTORS

David R. Pomije
Chairman of the Board, President and Chief Executive Officer

Stanley A. Bodine
Executive Vice President

Richard T. Guidera
President
The Guidera Group, Inc.

George E. Mileusnic
Senior Vice President and Chief Financial Officer
The Coleman Company

CORPORATE OFFICERS

David R. Pomije
Chairman of the Board, President and Chief Executive Officer

Stanley A. Bodine
Executive Vice President

Jeffrey R. Gatesmith
Vice President of Retail Operations and Human Resources

Robert M. Hiben
Controller

Michael B. Hinnenkamp
Vice President of Merchandising and Information Systems

INDEPENDENT AUDITORS

Ernst & Young
Minneapolis, Minnesota

CORPORATE COUNSEL

Mackall, Crounse & Moore
Minneapolis, Minnesota

TRANSFER AGENT

Norwest Bank Minnesota, N.A.
South St. Paul, Minnesota

ANNUAL MEETING

The annual shareholders' meeting will be held on Tuesday, August 5, 1994 at 10:00 a.m. at the Minneapolis Marriott Southwest in Minnetonka, Minnesota.

COMMON STOCK

The Company's common stock was first traded publicly on August 12, 1992. The stock is listed on the NASDAQ market under the symbol "FNCO." The table below presents the high and low closing prices of the Company's common stock for the second through the fourth quarters of fiscal 1994 as reported by NASDAQ. All other quarters reflect the high and low bid prices of the Company's common stock as reported by NASDAQ.

	1994 Fiscal Quarter		*1993 Fiscal Quarter*	
	High	*Low*	*High*	*Low*
First	$14½	$ 7¾	NA	NA
Second	16¾	12¼	$ 5½	$5
Third	20¼	14⅜	9½	5½
Fourth	20¼	14½	17¼	9

At June 20, 1994, there were 5,766,454 shares of common stock outstanding, held by 403 shareholders of record. The Company has not paid any cash dividends on its common stock and does not anticipate paying cash dividends in the foreseeable future. Under the Company's current bank credit agreement, the Company is prohibited from paying dividends without the bank's prior written consent.

10-K REPORT

Shareholders who wish to obtain a copy of our Annual Report on Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended April 3, 1994, may do so by writing Investor Relations at the Corporate Address.

FuncoLand®

YOUR SOURCE FOR INTERactive · Entertainment™

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